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Special Use Valuation: The Complexities of Economic Engineering

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SPECIAL USE VALUATION: THE COMPLEXITIES OF ECONOMIC ENGINEERING

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Systems of taxation generally rest upon three principal foundations: (1) the generation of revenue in support of services provided at one or more levels of government, (2) the redistribution of income or wealth, and (3) the modification of behavior patterns or social or economic relationships in accordance with some objective society presumably holds.[1] Special use valuation,[2] having a stated objective of reducing the federal estate tax liability for farm businesses[3] and eligible non-farm[4] businesses,[5] clearly falls into the second classification. In accomplishing this objective, special use valuation affects revenue generation in a negative manner and has an effect on income and wealth distribution.[6]

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1. *See generally* Harl, *The Future of Government Regulation of Agriculture: Implications of Tax Policy for Agriculture*, 5 N. ILL. U. L. REV. 279 (1983).

2. *See* I.R.C. § 2032A (West 1983). Section 2032A provides that qualified property may be valued, for estate tax purposes, at an amount that represents its actual earning capacity rather than at an amount that represents its "highest and best" use. *See* H. R. REP. No. 1380, 94th Cong., 2d Sess. 5, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3356, 3359-60.

3. I.R.C. § 2032A(b) (2) (A). Both special use valuation procedures, § 2032A(e) (7) (cash rent capitalization approach) and § 2032A(e) (8) (five factor valuation formula) are available for eligible farmland. For a discussion of special use valuation procedures for eligible farmland, *see generally* 5 N. HARL, AGRIC. LAW § 43.03[2] [b], [c] (1983).

4. I.R.C. § 2032A(b) (2) (B). Only the five factor valuation formula authorized by I.R.C. § 2032A(e) (8) may be used for valuation of land used in non-farm businesses. *See* I.R.C. § 2032A (e) (8) (West 1983).

5. Federal estate tax relief does not, however, extend to all business assets. Land is the only business asset to receive this relief. For a discussion of the implications of providing federal estate tax relief only for land, see Boehlje & Harl, *"Use" Valuation Under the 1976 Tax Reform Act: Problems and Implications*, 19 JURIMETRICS J. 100, 121-30 (1978).

6. *See* 5 N. HARL, *supra* note 3, § 43.03 [2] [b] [i] n. 58.

Another significant feature of special use valuation, which was not recognized at the time of its enactment in 1976,[7] is the enormous complexity of the statute and resulting regulations and rulings. This complexity was unexpected because the statute was designed to engineer a seemingly simple outcome. In slightly more than seven years, special use valuation has managed to make impressive progress toward becoming the most complex section of the Internal Revenue Code (I.R.C.). The need for complexity is clear: any tax provision assuring preferential treatment for one group of taxpayers must necessarily "fence out" ineligible taxpayers.[8] A high level of statutory intricacy is assured whenever the benefits of taking advantage of a provision are substantial and there are significant numbers of taxpayers capable of meeting the eligibility requirements.

In this Article the principal emphasis is on identifying the pre-death qualification requirements for eligibility and the points to watch in avoiding post-death recapture.

I. PRE-DEATH ELIGIBILITY

A. PRELIMINARY REQUIREMENTS

Farm or ranch real estate, to be eligible for special use valuation, must be used as a farm for farming purposes.[9] Both "farm"[10] and "farming purposes"[11] are defined broadly in the I.R.C. Residential buildings and related improvements occupied on a regular basis by the owner, tenant, or employee of the owner or tenant and improvements functionally related to farming are

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7. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1856.

8. *See generally* Harl, *Special Use Valuation: An Exercise in Fence Building*, 68 A.B.A.J. 50 (1983) (discussion of the "fencing out" of taxpayers ineligible for preferential treatment under § 2032A).

9. I.R.C. § 2032A (b) (2) (A).

10. *Id.* § 2032A(e)(4). The I.R.C. defines the term "farm" to include "stock, dairy, poultry, fruit, furbearing animal and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands." *Id.*

11. *Id.* § 2032A(e)(5). The I.R.C. defines "farming purposes" as follows:

> (A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
> (B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
> (C) (i) the planting, cultivating, caring for, or cutting of trees, or
> (ii) the preparation (other than milling) of trees for market.

Id.

eligible for special use valuation if the other statutory requirements are met.[12]

Timber production and tree farming pose special problems.[13] The Internal Revenue Service (IRS) took the position in 1980 that merchantible timber and young growth were properly treated as a crop and not part of the real estate.[14] The result was that the value of the trees was ineligible for special use valuation. Congress responded by authorizing estate representatives to elect to treat growing trees in "qualified woodlands" as part of the realty of persons dying after 1981.[15] The I.R.C. defines "qualified woodlands" as real property "used in timber operations, and . . . is an identifiable area of land. . . for which records are normally maintained in conducting timber operations."[16]

The special use valuation options may be used only for federal estate tax purposes.[17] Special use valuation is not available for computing the generation skipping tax[18] and has no relevance in valuing property for federal gift tax purposes.[19] Special use valuation is not applicable when computing federal income tax liability on a sale or exchange except that special use valuation establishes the devisee's income tax basis of the property.[20] In general, special use valuation does not apply for state estate or state inheritance tax purposes although several states have adopted similar statutory procedures for computing state death tax liability.[21]

B. VALUATION METHODS

Farmland may be valued under either the cash rent capitalization approach[22] or the five factor formula.[23] By a

12. *Id.* § 2032A (e) (3). *See* Ltr. Rul. 8128017, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5063 (1981) (one-half acre tract containing farm dwelling that was rented to third party who was not associated with farming operation not eligible for special use valuation).

13. *See* 5 N. HARL, *supra* note 3, § 43.03 [2] [a].

14. Ltr. Rul. 8046012, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4855 (1980).

15. I.R.C. § 2032A (e) (13).

16. *Id.*

17. *Id.* § 2032A (a) (1). Section 2032A (a) (1) provides, "If . . . the executor elects the application of this section . . . then, for purposes *of this chapter*, the value of qualified real property shall be its value for the use under which its qualifies . . . as qualified real property." *Id.* (emphasis added). Section 2032A (a) (1) is within chapter 11 of the I.R.C., which is entitled "Estate Tax."

18. *See* I.R.C. §§ 2601-2622.

19. The value of a gift of real property under a special use value election is the fair market value of the property, unreduced by the amount of any potential recapture tax. Rev. Rul. 230, 1981-2 C. B. 186.

20. I.R.C. § 1014 (a) (3).

21. *See, e.g.*, IOWA CODE ch. 450B (1983); OHIO REV. CODE ANN. § 5731.01 (Page 1982 Supp.); TENN. CODE ANN. § 30.1621 (c) (1983).

22. I.R.C. § 2032A (e) (7).

23. *Id.* § 2032A (e) (8).

substantial margin, the cash rent capitalization option generally produces the greatest reduction of federal estate tax and, not surprisingly, is the most widely used.

The cash rent capitalization method for special use valuation relies upon average annual gross cash rentals on comparable land in the locality, used for farming purposes, for the last five full calendar years before the decedent's death.[24] Average annual local and state real estate taxes, if any, are subtracted from the cash rent figure.[25] The difference is divided by the average annual effective interest rate for all new Federal Land Bank loans during this same time period.[26]

Except when an executor proves that actual cash rent figures on comparable land in the locality are not available, in which case cash rent figures may be synthesized from crop share lease information,[27] cash rent figures must be obtained from at least one actual tract of comparable land.[28] Neither data from surveys of "expected" cash rents[29] nor appraisals or estimates of rental value may be used in the cash rent capitalization formula.[30] Only rentals from arm's length lease arrangements may be used in the formula;[31] rentals from leases between family members that "do not provide a return on the property commensurate with that received under leases between unrelated parties in the locality are not acceptable. . . ."[32] The regulations provide that tracts under

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24. *Id.* § 2032A (e) (7) (A). The logic of basing land values on cash rent figures derives from the income capitalization theory for valuing a resource. *See* Harl, *Special Use Valuation Under I.R.C. § 2032A: Planning to Meet Pre-Death Requirements*, 16 INST. ON EST. PLAN. ¶ 1501.1 (1982). *See also* 5 N. HARL., *supra* note 3, § 43.03 [2] [b] [i].

25. I.R.C. § 2032A (e) (7) (A) (i). The IRS has taken the position that if comparable rented land is exempt from property tax, no amounts for property taxes may be subtracted from the annual cash rent figure. Ltr. Rul. 8323001, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 2584 (1983).

26. I.R.C. § 2032A (e) (7).

27. *Id.* § 2032A (e) (7) (B) (i). If there is no comparable land from which average annual gross cash rents may be obtained, "average net share rentals" from crop share leases may be used for deaths after 1981. *See id.* The term "net share lease" means the landowner's portion of the crop share return from the land minus the "cash operating expenses which, under the lease, are paid by the lessor." *Id.* § 2032A (e) (7) (B) (ii). If produce is disposed of in an arm's length transaction "within a period no longer than the period established by the U.S. Department of Agriculture for its price support program immediately following the date or dates on which the produce is received or constructively received by the lessor, the . . . gross amount received in the disposition will be the gross value of the produce." S. REP. NO. 97-144, 97th Cong., 1st Sess. 135 *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 235. If the produce is not disposed of in an arm's length transaction, the price used is the "weighted average price for which the produce sold on the closest national or regional commodities market to the farm property" on the date of actual or constructive receipt of the property. *Id.*

28. *See* I.R.C. § 2032A (e) (7) (A) (i).

29. *See* ECON. RESEARCH SERV., U.S. DEP'T OF AGRIC., FARM REAL ESTATE MARKET DEV. 38-41 (1983). Survey data of expected cash rents are published as state averages but are available by crop reporting district. *Id.* at 20-22.

30. Treas. Reg. § 20.2032A-4 (b) (2) (iii) (1980).

31. *Id.* § 20.2032A-4 (b) (1).

32. *Id.* § 20.2032A-4 (b) (2) (ii).

material participation leases may not be used as a source of cash rental information.[33]

C. ELIGIBILITY REQUIREMENTS

1. The Fifty Percent Test and Passage to Qualified Heirs

To be eligible for special use valuation, the adjusted value of farm or other closely held business real and personal property[34] must comprise at least fifty percent of the adjusted value of the gross estate.[35] Furthermore, fifty percent of the adjusted value of the gross estate must pass to qualified heirs.[36] Personal property may be considered in meeting the fifty percent test only if it is used together with the real property that is being specially valued.[37]

The "adjusted value" of the gross estate is the gross estate less allowable unpaid indebtedness attributable to the property.[38] Adjusted value of real or personal property is defined as the fair market value less allowable indebtedness attributable to the property.[39] For several years the IRS took the position that an indebtedness secured by property under a special use value election had to be reduced by the same ratio as the reduction of special use value from fair market value.[40] In 1983, however, the IRS ruled that the full amount of an unpaid mortgage, for which the decedent was personally liable and that was enforceable against other property of the estate, was allowable as a deduction when the entire amount of mortgaged property was included in the gross estate.[41]

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33. *Id.* § 20.2032A-4 (b) (1).

34. The value of a note recievable, even though secured by farm property, is not considered to be farm real or personal property for purposes of the 50% test. Ltr. Rul. 8115015, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5048 (1981). Likewise, the value of an installment land contract or contract for deed is neither farm real nor personal property for purposes of special use valuation or the percentage eligibility tests. Ltr. Rul. 8221005, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5035 (1982); Ltr. Rul. 8246020, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5032 (1982). A remainder interest in real property is not eligible for special use valuation if no qualifed heir receives a present interest in the property. Ltr. Rul. 8223004, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5030 (1980) (value of remainder interest does not count for purposes of the 50% test).

35. I.R.C. § 2032A (b) (1) (A).

36. *Id.* § 2032A (b) (1) (A) (ii).

37. Estate of Geiger, 80 T.C. 484 (1983) (personal property from hardware business could not be used to meet requirements to specially value farmland).

38. I.R.C. § 2032A (b) (3) (A).

39. *Id.* § 2032A (b) (3) (B). Section 2032A (b) (3) (B) provides that adjusted value is the value of the property reduced by amounts allowable as a deduction under I.R.C. § 2053 (a) (4). *See id.* § 2053 (a) (4) (allows a deduction from taxable estate of unpaid indebtedness).

40. *See, e.g.*, Ltr. Rul. 8120017, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5183 (1981) (deductible portion of mortgage is computed by dividing special use value by fair value and multiplying by total amount of mortgage); Ltr. Rul. 8108179, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5042 (1981) (decedent may deduct portion of mortgage that bears same ratio to total mortgage as special use value bears to fair market value); Ltr. Rul. 8052030, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4860 (1980) (deduction limited to portion of unpaid mortgage that bears same ratio to total mortgage as special use value bears to fair market value).

41. Rev. Rul. 81, 1983-1 C.B. 230.

As noted above, at least fifty percent of the adjusted value of the gross estate must be comprised of farm or other business real and personal property and that amount or more must pass to qualified heirs.[42] The definition of a qualified heir, which includes any member of the decedent's family,[43] is fundamental in determining whether the fifty percent test is met.[44] This definition is applied to the decedent-to-be as the "base person."[45]

For persons dying before 1982, the term "member of family" included an individual's ancestors or lineal descendants, lineal descendants of the grandparents of the base person, the individual's spouse, and the spouse of any included descendant.[46] For persons dying after 1981, the definition of "member of family" was narrowed to include only the base person's ancestors, the individual's spouse, lineal descendants, lineal descendants of the spouse, lineal descendants of the parents of the individual, and the spouse of any lineal descendant.[47] Legally adopted children are treated as children of blood relationship.[48] Adoption apparently relates back to the birth of the adopted person.[49]

As noted previously,[50] to be eligible for special use valuation, qualified real property must have been "acquired from or passed from the decedent to a qualified heir of the decedent. . . ."[51] Prior to 1981, property met the "passing from" requirement if it met the

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42. I.R.C. § 2032A (b) (1) (A).

43. *Id.* § 2032A (e) (1).

44. *See id.* § 2032A (b) (1) (A) (ii). The term "member of family" is also utilized in special use valuation to determine who can provide material participation before death. *Id.* § 2032A (b) (1) (C) (ii). A member of the decedent's family must provide material participation to avoid recapture after death. *Id.* § 2032A (c) (6) (B) (i). The decedent or a member of the decedent's family can meet the ownership and qualified use tests before death. *Id* § 2032A (b) (1) (C) (i). A member of the qualified heir's family can acquire qualified real property from a qualified heir after death without triggering recapture. *Id.* § 2032A (c) (1) (A).

45. For purposes of post-death recapture, "member of family" applies to each qualified heir's family. Each qualified heir is the "base person." *See* Ltr. Rul. 8307110, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 829 (1983) (decedent's half-brother was member of decedent's family but not a member of family of decedent's children, who were qualified heirs). See *infra* notes 176-79 and accompanying text for an example of the "member of family" requirement.

46. *See* I.R.C. § 2032A (e) (2) (West 1981), *amended by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421 (i), 95 Stat. 172, 312. *See* Estate of Cowser, 80 T.C. 783 (1983) (grandniece of decedent's spouse was not a member of family of decedent who died before 1982).

47. I.R.C. § 2032A (e) (2) (West 1983). The spouse of a lineal descendant remains a family member even though the descendant dies. *See* Rev. Rul. 236, 1981-2 C.B. 172-73 (unremarried widower of decedent's daughter remained qualified heir).

48. *See* I.R.C. § 2032A (e) (2). An "acknowledged child" is not considered to be a member of the family for purposes of special use valuation. Rev. Rul. 179, 1981-2 C.B. 172; Ltr. Rul. 8032026, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4846 (1980). Likewise, an unadopted foster child is not considered to be a member of the family. Ltr. Rul. 8033018, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4847 (1980).

49. *See* I.R.C. § 2032A (e) (2).

50. *See supra* note 34-37 and accompanying text.

51. I.R.C. § 2032A (b) (1).

requirements of section 1014 (b)[52] of the I.R.C.[53] Property passing by purchase from the estate of the decedent did not meet the "passing from" test.[54]

A 1981 amendment, retroactive to January 1, 1977, permits property to pass by purchase and not lose eligibility for special use valuation.[55] Under the amendment, property is considered to have been acquired from or to have passed from the decedent if (1) the property receives an adjustment in income tax basis in passing from the decedent, (2) the property was acquired by "any person" from the estate, or (3) the property was acquired by "any person" from a trust, to the extent the property was includible in the decedent's estate.[56] If the property is corporate stock that passes under a buy-sell agreement at the decedent's death, the proportionate part passing indirectly to qualified heirs is eligible for special use valuation.[57]

The amendment to allow qualified real property to pass to qualified heirs by purchase has raised a substantial question of potential income tax liability on the resale of the property by the purchasing qualified heir.[58] If the property is purchased by a qualified heir from the estate, the qualified heir's income tax basis is the special use value established in the estate, increased by the amount of gain recognized to the estate.[59] The estate does not recognize gain on the sale for income tax purposes except to the extent that the fair market value on the sale exceeds the fair market value of the property on the date of the decedent's death.[60]

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52. *See id.* § 1014 (b) (describing property considered acquired from or passed from the decedent).

53. *See Id.* § 2032A (e) (9) (A). *See* Ltr. Rul. 8117181, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶5050 (1981) (property passing in satisfaction of pecuniary bequest eligible for special use valuation).

54. *See* I.R.C. § 1014 (b). Section 1014 (b) does not provide for property purchased from an estate. *See* Kalbac v. Commissioner, 298 F.2d 251 (8th Cir. 1962) (shares purchased from estate pursuant to option conferred by will were not acquired by bequest, devise, or inheritance); Vallesky v. Nelson, 271 F.2d 6 (7th Cir. 1959) (basis of property acquired by testamentary right to purchase is cost). *Compare* Ltr. Rul. 8110023, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5044 (1981) (farmland ineligible for special use valuation when devisees contributed funds to pay other bequests and costs of estate settlement) *with* Ltr. Rul. 8140008, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5068 (1981) (that the title to realty passed immediately to the heirs as a matter of state law subject to being retaken by the estate representative to pay debts and costs apparently was sufficient to meet the "passing from" test).

55. I.R.C. § 2032A (e) (9) (*amended by* Pub. L. No. 97-34, 96 Stat. 23655 (1982)). *See* Ltr. Rul. 8217075, [Priv. Ltr. Rul.] FED TAXES (P-H) ¶ 5029 (1982) (stock redeemed under § 303 deemed to have met "passing from" requirement); Ltr. Rul. 8206050, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5028 (1982) (land eligible for special use valuation even though qualified heirs "purchased" the land from the estate by assuming a mortgage placed on the property by the executor to enable cash distributions to be made to other qualified heirs).

56. I.R.C. § 2032A (e) (9).

57. Ltr. Rul. 8223017, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5054 (1982).

58. *See generally* Harl, *Special Use Valuation of Farmland Under I.R.C. Section 2032A With Emphasis on Planning to Meet the Pre-Death Requirements,* 16 INST. ON EST. PLAN. ¶ 1502.3 (1982).

59. *See* I.R.C. § 1040 (c). If an undivided interest in land is acquired by purchase and another undivided part is received by inheritance, the income tax basis figures would appear to merge. *Cf.* Rev. Rul. 309, 1967-2 C. B. 263.

60. I.R.C. § 1040 (a), (b).

For example, suppose *G* dies intestate, owning 320 acres of farmland valued at $640,000 on the date of his death and the special use value is $300,000. One of *G*'s grandchildren, *R*, has been farming the 320 acres for several years and wants to purchase the land. The children of *G* agree that a selling price of $640,000, the fair market value of the land at the date of sale, would be acceptable. If the estate sells the land for $640,000, the estate will recognize no gain. Even though *R* pays $640,000 for the 320 acres, *R*'s income tax basis will be only $300,000, the special use value. If *R* resells the land for $640,000, *R* will have a $340,000 gain.

If the fair market value at the time of the sale was $700,000, the estate will recognize $60,000 of gain and *R*'s income tax basis will be $360,000. The estate will recognize gain to the extent the fair market value at the time of the sale exceeds the fair market value at death and the amount of recognized gain will be added to the purchaser's income tax basis.[61]

If the land was sold by *G*'s estate to *R* for $600,000 when the fair market value at the time of the sale was $700,000, the estate will still recognize $60,000 of gain and *R*'s income tax basis will be $360,000. Even though the actual selling price is less than the date of death value, the estate still recognizes gain to the extent the fair market value on the date of the sale exceeds fair market value at death.[62]

Land acquired from the estate by purchase, or transferred in satisfaction of a pecuniary bequest, is deemed to have been held for more than one year if it is subsequently sold to another qualified heir.[63] Thus, the land automatically acquires a holding period of more than one year.

If an estate enters into an installment sale of special use value land, no gain will be recognized on the sale, except to the extent that the fair market value on the sale exceeds the fair market value at the date of death.[64] Distribution of the installment obligation from the estate, however, would appear to trigger recognition of gain in the obligation, unshielded by the provision sheltering gain in the land from recognition on the initial sale by the estate.[65] This treatment is in contrast to the treatment accorded installment obligations entered into by the decedent before death.[66]

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61. *Id.* § 1040 (c).

62. *Id.* § 1040 (a).

63. *Id.* § 1223 (12), *amended by* Technical Corrections Act of 1982, Pub. L. 97-448, § 104 (b) (3) (C), 96 Stat. 2365, 2382.

64. I.R.C. § 1040 (a).

65. *See* Rev. Rul. 159, 1955-1 C. B. 391 (distribution of installment obligation from trust to beneficiary was taxable disposition).

66. *See* I.R.C. § 691 (a) (4). A recipient of an installment obligation from a decedent recognizes

2. The Twenty-Five Percent Test

At least twenty-five percent of the adjusted value of the decedent's gross estate must be qualified farm or other closely held business real property that was acquired from or passed from the decedent to a qualified heir.[67] Only real property passing to a qualified heir is eligible for special use valuation.[68]

The executor need not elect to include all eligible real property in an estate for special use treatment, but the election must include sufficient realty to equal or exceed twenty-five percent of the adjusted value of the gross estate.[69] In the event the $750,000 limit on reduction[70] of the gross estate precludes electing at least twenty-five percent of the estate, the allowable reduction is prorated over twenty-five percent of the adjusted value of the gross estate.

3. Qualified Use Test

In the final regulations issued in 1980 the Department of the Treasury took the position that, for special use valuation eligibility, an "equity" interest such as an interest in a crop share or livestock share lease must be held in the farm operation by the decedent-to-be (1) at the time of death and (2) for five or more of the last eight years before death, and by each qualified heir during the entire recapture period after death.[71] Under this position, requiring the decedent to be "at risk" in the farm operation, a cash rent lease, even to a family member, failed to meet the test.[72]

The regulations drew substantial critical comment. On April 27, 1981, the IRS announced a change of interpretation permitting the qualified use test to be met by the decedent or a member of the decedent's family in the pre-death period.[73] Regulations to this

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income in respect of a decedent. Treas. Reg. § 1.691 (a)-5 (1957). *See* Clairborne v. United States, 648 F.2d 448 (6th Cir. 1981) (closing of a land transaction after death); Trust Co. of Georgia v. Ross, 262 F. Supp. 900 (N.D. Ga. 1966), *aff'd*, 392 F.2d 694 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968); Hedrick v. Commissioner, 63 T.C. 395 (1974).

67. I.R.C. § 2032A (b) (1) (B).

68. *Id.* § 2032A (b) (1).

69. Treas. Reg. § 20.2032A-8 (a) (2) (1980). For the procedure to be followed for reducing the value of property subject to an election made on or before August 30, 1983, see Rev. Proc. 49, 1980-2 C.B. 816.

70. *See* I.R.C. § 2032A (a) (2) (aggregate decrease in the value of qualified property under special use valuation shall not exceed $750,000).

71. Treas. Reg. § 20.2032A-3 (b) (1) (1980), *amended by* T.D. 7786, 1981-2 C.B. 174. *See* I.R.C. §§ 2032A (b), 2032A (c) (7).

72. Ltr. Rul. 8107142, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5032 (1980); Ltr. Rul. 8118002, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5051 (1980); Ltr. Rul. 8114033, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5844 (1980).

73. News Release R-147, [1982] FED. EST. & GIFT TAX REP. (CCH) ¶ 12,442, at 16,108 (April 27, 1981).

effect were issued.[74] Under the regulations, a cash rent lease to a member of the decedent's family does not preclude special use valuation. The amendment to the regulations did not, however, change the qualified use test in the post-death period. Each qualified heir, not including a member of the qualified heir's family, must have an equity or "at risk" interest in the farm operation in the post-death recapture period.[75]

The Economic Recovery Tax Act of 1981[76] amended the I.R.C., retroactive to January 1, 1977, permitting the decedent, or a member of the decedent's family to meet the qualified use test in the pre-death qualification period.[77] In accordance with the earlier announcement and the amendment to the regulations, the statutory change permits the decedent or a member of the decedent's family to meet the qualified use test.[78] The statutory amendment did not alter the qualified use test in the post-death recapture period; each qualified heir must have an equity interest in the farm operation after death.[79]

With the statutory change, there is no doubt about the compatibility of cash rent leases and special use valuation. In the pre-death period, cash rent leases are acceptable if the tenant is a family member.[80] In the post-death recapture period, cash rent leases after the two year grace period has elapsed result in immediate recapture of the lessor's savings in federal estate tax from special use valuation.[81]

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74. *See* Treas. Reg. § 20.2032A-3 (b) (1), *amended by* T.D. 7786, 1981-2 C.B. 174 (1981).

75. I.R.C. § 2032A (c) (6) (A). Section 2032A provides for a two year grace period from the date of the decedent's death in which the qualified heir need not hold the property in a qualified use. *Id.* § 2032A (c) (7) (A). The absence of an "at risk" interest will not cause a recapture during the grace period. *Id.*

76. Pub. L. No. 97-34, § 421 (b) (1), 95 Stat. 172, 306 (1981).

77. *Id.*

78. *See* Ltr. Rul. 8249014, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5037 (1982) (land cash rented to son met qualified use test because son was "at risk"); Ltr. Rul. 8147100, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5073 (1981) (cash rent lease to partnership comprised of decedent's sons as partners met the test; sons as partners were "at risk"); Ltr. Rul. 8149006, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5075 (1981) (cash rent lease to son as farm tenant met qualified use test; son was "at risk"). *But see* Ltr. Rul. 8201016, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5033 (1981) (cash rent lease to unrelated tenant failed to meet the qualified use test since there was no equity interest in the farm operation by landowner or member of family).

79. See *infra* notes 196-209 for a discussion of the post-death qualified use test. *See also* S. REP. No. 97-144, 97th Cong., 1st Sess. 134, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 234. The Senate Report provides, "The bill does not change the present requirement that the qualified heir owning real property after the decedent's death use it in the qualified use throughout the recapture period." *Id.* Identical language appears in the House Ways and Means Committee Report. *See* H. REP. No. 97-201, 97th Cong., 1st Sess. 169 (1981). For a discussion of the qualified use test two year grace period immediately following death, see *infra* notes 196-97.

80. *See* Schuneman v. United States, 570 F. Supp. 1327, 1329-31 (C.D. Ill. 1983) (qualified use test not met with cash rent lease at death to non-family member; lease provided for adjustment in rental if revenue to tenant fell below a specified level).

81. I.R.C. § 2032A (c) (6) (A). *See* Ltr. Rul. 8240015, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5055 (1982) (surviving spouse did not have equity interest in land rented to children under a "net lease").

The line between arrangements that do or do not create an equity interest in the lessor is not entirely clear. In one ruling, a "hybrid" cash rent lease met the qualified use test.[82] The lease assured the landowner of 40 bushels of corn or 13 bushels of soybeans; but the landowner received only the amount of actual production if production was less than the bushel amounts. The ruling held that the arrangement made the landowner sufficiently "at risk" to meet the qualified use test.[83] A word of caution would appear to be in order concerning this ruling: The almost de minimis at risk element in the lease arrangement raises a question of whether the ruling represents a firm base for pre-death or post-death planning.

Participation in the 1983 federal payment-in-kind program[84] did not make the idled land ineligible for special use valuation under the qualified use test if the landowner received agricultural commodities for idling the land.[85] In a March 1, 1983, announcement the IRS took the position that idling land under any government acreage diversion program would not preclude special use valuation eligibility or lead to recapture.[86]

When a life tenant is at risk by virtue of a crop share or livestock share lease, holders of a remainder or other future or successive interests in the same land would also seem to be at risk, at least concerning distributions of the income.[87] If income is not produced under an at risk arrangement, or if a discretionary distribution is made from the principal, a question exists whether the qualified use test is met.

4. Material Participation Test

The material participation test emphasizes involvement in financial affairs and management of the farm operation. In the pre-death eligibility period, the decedent or a member of the decedent's family must have materially participated in the operation of the farm or other business for five or more of the last eight years before

82. Ltr. Rul. 8217193, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5051 (1982).
83. *Id.*
84. 48 Fed. Reg. 1694 (1983).
85. Payment-in-Kind Tax Treatment Act of 1983, Pub. L. No. 98-4 § 3. 97 Stat. 7. For a discussion of the federal payment-in-kind program see Harl, *New Legislation to Solve Payment-in-Kind Program Tax Woes,* 5 J. AGRIC. TAX. & L. 3 (1983).
86. Announcement 83-43, 1983-10 I.R.B. 29.
87. *See generally* Harl, *Special use Valuation and Future Interests,* 5 J. AGRIC. TAX & L. 271, 276-77 (1983). *See also* 8 N. HARL, *supra* note 3, at § 62.04 [6] [C] [iii].

the earlier of retirement,[88] disability[89] or death.[90] For deaths occurring after 1981, a special rule applies to a surviving spouse who inherits qualified real property from a deceased spouse. When the property is acquired from or passes from the deceased spouse to a surviving spouse, and the surviving spouse is involved in "active management" of the farm or other business, active management substitutes for material participation.[91]

Even when active management substitutes for material participation, eligibility for special use valuation requires a surviving spouse to meet the material participation test[92] or active management test[93] for five or more of the last eight years before the earlier of retirement, disability or death.[94] However, the period of material participation by a retired or disabled spouse may be tacked on to the period of active management by a surviving spouse.[95]

For example, suppose *H* retires from 40 years of active farming in early 1984 and commences receiving social security benefits. *H*'s farmland is then rented under a nonmaterial participation crop share lease to an unrelated farm tenant.[96] At *H*'s death in 1991, the material participation test would be met in *H*'s estate. If the land was left to *H*'s wife, who did not commence active management until *H*'s death in 1991, and she dies in 1993, her estate should be eligible for special use valuation. Even though she did not have material participation or active management for five or more of the last eight years before her death, *H*'s pre-retirement material participation counts for purposes of the wife's eligibility.[97] It is important to note, in meeting the material participation test,

88. The I.R.C. defines "retirement" as the receiving of social security benefits under Title II of the Social Security Act. I.R.C. § 2032A (b) (4) (A) (i).

89. The I.R.C. defines "disability" as mental or physical impairment precluding material participation. *Id.* § 2032A (b) (4) (B).

90. *Id.* § 2032A (b) (1) (C).

91. *Id.* § 2032A (b) (5) (A). Section 2032A (b) (5) (A) provides that "active management of the farm or other business by the surviving spouse shall be treated as material participation by such surviving spouse in the operation of the business." *Id.* It is not necessary that the deceased spouse have actually elected special use valuation. *Id.* § 2032A (b) (5) (B). However, it is necessary for the deceased spouse to have held "qualified real property." *Id.* § 2032A (b) (5) (A). Therefore, it appears doubtful that a spouse dying before January 1, 1977, could have held qualified real property.

It would appear that a surviving spouse must have been a surviving spouse at the time of active management in order for active management to substitute for material participation. *See id.* § 2032A (b) (5) (A). Active management in a farm operation by a spouse before becoming a surviving spouse may not count toward the material participation requirement.

92. *Id.* § 2032A (b) (1) (C) (ii). A surviving spouse can meet the material participation test personally or through a member of the decedent's family. *See id.* § 2032A (b) (5) (C).

93. *Id.* § 2032A (b) (5) (A). A surviving spouse must meet the active management test personally. *See id.*

94. *Id.* § 2032A (b) (1) (C).

95. *Id.* § 2032A (b) (5). The tacking provision of § 2032A (b) (5) was added by the Technical Corrections Act of 1982, Pub. L. No. 97-448, § 104 (b), 96 Stat. 2365, 2381.

96. A crop share lease is necessary to meet the qualified use test when the lease is to a tenant who is not a member of the decedent's family. See *supra* note 71-72 and accompanying text.

97. See *supra* note 88 for the definition of *"retirement"*

that material participation can be by the decedent-to-be or a member of the family. Active management as a substitute for material participation, however, *can come only from the decedent-to-be.*[98]

5. Definition of Material Participation

Material participation is an important concept in special use valuation and is designed to exclude mere investors from eligibility.[99]

Statutorily, material participation is "determined in a manner similar" to the manner used for purposes of the imposition of social security tax on net earnings from self-employment.[100] For social security purposes, material participation treats income from real property rental as self-employment income.[101] In addition, for social security purposes, four tests have been developed, any one of which if met constitutes material participation.[102] The special use

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98. I.R.C. § 2032A (c) (7) (B) (i). For qualified heirs who are under age 21 or are disabled, active management may be satisfied by a fiduciary. *Id.* § 2032A (c) (7) (B) (ii).

99. The qualified use test can be met by a mere investor by using a crop share lease. Material participation requires personal involvement in management by the decedent or a member of the decedent's family. The test can only be met if an absentee owner is fortunate enough to have a family member who can provide material participation because material participation cannot be met by an unrelated agent. See *infra* notes 111-15.

100. I.R.C. § 2032A (e) (6).

101. *Id.* § 1042 (a) (1). Real estate rentals are not self-employment income under I.R.C. § 1402 (a) (1) but income derived by an owner of land is included in determining net earnings from self-employment if the income is derived:

> under an arrangement between such owner . . . and another person [which] provides that such other person shall produce agricultural or horticultural commodities . . . on such land, and that there shall be material participation by the owner or tenant . . . in the production or the management of the production of such agricultural or horticultural commodities; and there is material participation by the owner. . . with respect to any such agricultural or horticultural commodity.

Treas. Reg. § 1.1402 (a) (13) (d) (1963).

102. *See* 20 C.F.R. § 404.1053 (c) (3) (1983); U.S. SOC. SEC. AD., SOCIAL SECURITY HANDBOOK §§ 1224-1322 (7th ed. 1982).

Under the first test material participation is established if the landlord has an arrangement for participation and does any three of the following:

(1) Advances, pays, or stands good for a significant part of the cost of production.
(2) Furnishes a significant part of the tools, equipment and livestock used in producing commodities.
(3) Makes periodic inspections of the production activities.
(4) Advises and consults with the tenant periodically.

U.S. SOC. SEC. AD., SOCIAL SECURITY HANDBOOK § 1224.

Under the second test a landlord may be materially participating if the individual regularly and frequently makes decisions that significantly affect the success of the enterprise. What, when, and where to plant, cultivate, dust, or spray, when to harvest, sell, or rent count toward satisfying this test. *Id.* § 1230.

Under the third test the landlord may establish material participation if the individual works at least 100 hours over a five week period on activities connected with the produciton of the crop. If the landlord does not work 100 hours or works less than five weeks, this test may still be met if the work done adds up to a significant contribution to the production of the crop. *Id.* § 1231.

value regulations, although similar to the social security rules, are significantly different in several respects[103] and provide that:

> No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, productive activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation.[104]

In *Estate of Catherine Coon*[105] a brother of the decedent, as the material participator, did not "regularly advise or consult" in the operation of land rented under a crop share lease to an unrelated tenant.[106] The tenant owned the machinery and equipment and decided when to plow, plant and harvest.[107] The Tax Court upheld the spirit of the regulation in denying special use valuation.[108]

6. Definition of Active Management

The I.R.C. defines "active management" as "the making of the management decisions of a business (other than the daily

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The fourth test allows the landlord to meet the material participation test even if the individual cannot satisfy the first three tests. The fourth test takes into account the landlord's total activities. Thus, although a landlord may not quite satisfy one of the other tests, actions, based upon the "total picture," may be sufficient to satisfy the fourth test. *Id.* § 1232.

103. The most significant difference between the social security regulations and the special use value regulations is that the latter omit the test of working 100 hours or more spread over five or more weeks. *Compare* 20 C.F.R. § 404.1053 (c) (3) (1983) *with* Treas. Reg. § 20.2032A-3 (e) (2) (1980).

104. Treas. Reg. § 20. 2032A-3 (e) (2) (1980).

105. 81 TAX CT. REP. DEC. (P-H) ¶ 32, at 315 (1983).

106 Estate of Catherine Coon, 81 TAX CT. REP. DEC. (P.H.) § 32, at 315 (1983).

107. *Id.* at 317.

108. *Id.* at 319, 321.

operating decisions)."[109] The Senate Finance Committee report states:

> [T]he determination of whether active management occurs is factual, and the requirement can be met even though no self-employment tax is payable under section 1401 by the spouse with respect to income derived from the farm or other trade or business operation. Among the farming activities, various combinations of which constitute active management, are inspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substantial number of the management decisions of the business operation, and approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended. Examples of management decisions are decisions such as what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations, and what capital expenditures the trade or business should undertake.[110]

There is no specific statutory support for the statement that self-employment tax may not be payable when the active management test is met. Moreover, no regulations have been issued, even in proposed form, concerning the meaning of active management.

7. Effect of Material Participation by an Agent

Before 1974, material participation for social security purposes could be attained by an agent of the landowner such as a farm manager.[111] A 1974 amendment, however, requires that material participation be achieved by the landowner "determined without regard to any activities of an agent of such owner . . . in the production or the management of the production of such agricultural or horticultural commodities."[112] Because of this amendment, the material participation requirement cannot be met

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109. I.R.C. § 2032A(e)(12).

110. S. REP. No. 97-144, 97th Cong., 1st Sess. 134-35, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 108.

111. *See* 5 N. HARL, *supra* note 3, § 43.03[2][d][vi] nn. 121-22.

112. Pub. L. No. 93-368, 88 Stat. 420, 422 (1974) (amending 26 U.S.C. § 1402(a)(1)).

by an agent either for self-employment tax or special use valuation purposes. Similarly, the activities of an employee are not imputed to a landowner.[113] Activities of a family member as agent, however, do count for purposes of meeting the material participation requirement for special use valuation.[114]

Even though the material participation test cannot be satisfied through an agent, the presence of an agent does not preclude material participation by the landowner or member of the landowner's family.[115]

8. Effect of Post-Death Qualification

In some instances a post-death review of the pre-death material participation record may indicate that the material participation test was met even though it was not recognized for purposes of payment of self-employment tax or reduction of social security benefits. A major consideration in deciding whether to open the issue is the potential exposure to payment of additional self-employment tax.[116] Payment of self-employment tax does not conclusively establish whether the material participation test has been met.[117] If no self-employment tax has been paid, however, material participation is presumed not to have occurred unless the estate demonstrates otherwise and the additional self-employment tax is paid.[118]

Because the three year period for the assessment of self-employment tax starts running upon the filing of Form 1040,[119] an estate asserting that the decedent had participated materially could be required to pay self-employment tax for years in which the time for assessment had not run.[120] Apparently, the estate is liable for the additional tax only to the extent that the three year period

113. Treas. Reg. § 20.2032A-3 (e) (1).

114. *Id.* Uncompensated activities by a member of the decedent's family may constitute material participation when the decedent was incapable of handling business affairs and a family member or members handled those affairs without power of attorney or conservatorship. *See* Ltr. Rul. 8149002, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5074 (1981) (decedent had suffered a stroke, two sons, who were attorneys, managed the farm under oral crop share lease; decedent had been reporting no self-employment income).

115. *See* Treas. Reg. § 20.2032A-3 (g) example 4 (1980).

116. If a decedent has clearly and unambiguously met the material participation test, the estate may have no option, ethically, other than to raise the issue and pay the additional tax.

117. *See* Treas. Reg. § 20.2032A-3 (e) (1) (1980).

118. *Id.*

119. Rev. Rul. 185, 1982-2 C.B. 396. *But see* Rev. Rul. 39, 1979-1 C.B. 435-36 (for purposes of liability for social security tax on tip income, the period for assessment of tax does not run if the proper schedule is not filed and tax is not paid).

120. *See* Rev. Rul. 32, 1983-1 C.B. 226 (payment of delinquent self-employment tax for last three years before death sufficient to meet material participation requirement); Ltr. Rul. 8207006, [Priv. Ltr. Rul] FED. TAXES (P-H) ¶ 5042 (1982) (payment of delinquent self-employment taxes for years in which statute of limitations did not foreclose sufficient to satisfy material participation).

before death is part of the five of eight years before retirement, disability, or death.[121]

9. Participation in Acreage Diversion Programs

By virtue of federal legislation enacted in 1983, participation in the 1983 payment-in-kind government farm program[122] does not make the idled land ineligible for special use valuation because of absence of material participation if the landowner received agricultural commodities for idling the land.[123] The IRS has announced that participation in a government acreage diversion program does not jeopardize special use valuation.[124]

10. Present Interest Test

Real property is eligible for special use valuation only if a qualified heir receives a present interest from the decedent.[125]

a. Discretionary Trusts

Special use valuation requires that at least one qualified heir have a present interest or special use valuation is denied.[126] In 1980, the IRS ruled that if a trustee had discretion in paying income or principal to a qualified heir, the qualified heir would not have a present interest.[127] In light of this IRS position, the problems in meeting the present interest requirement were especially acute for trusts in which the trustees had discretionary spray powers or a discretionary right to invade principal for the benefit of individuals in addition to those holding the income interest.

For typical two-trust marital deduction wills, a present interest was assured in the marital share but the nonmarital share often

121. Rev. Rul. 32, 1983-1 C.B. 226.

122. 48 Fed. Reg. 1694 (1983).

123. Payment-in-Kind Tax Treatment Act of 1983, Pub. L. No. 98-4, § 3, 97 Stat. 7.

124. *See* Announcement 83-43, 1983-10 I.R.B. 29. The standing of Announcement 83-43 is clouded by the fact that it was obviously prepared hurriedly and contained one serious error on the self-employment status of income received from idling land under government acreage diversion programs. The law is now well settled that payments received for idling land under government acreage diversion programs are self-employment income to the landowner only if the landowner materially participated in the production of income. 4 HARL, *supra* note 3, § 37.03 [6]. Yet, the March 1, 1983, IRS Announcement proclaimed that all income from land diversion under government programs was properly considered to be self-employment income. *See* Announcement 83-43 1983-10 I.R.B. 30. The announcement did not reflect the state of the settled law concerning that point.

125. Treas. Reg. § 20.2032A-3 (b) (1) (1980). *See* Ltr. Rul. 8244001, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5027 (1982).

126. Ltr. Rul. 8244001, [Priv. Ltr. Rul.] FED. TAXES (P.H.) ¶ 5027 (1982).

127. Ltr. Rul. 8020011, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4841 (1980).

involved trustee discretion. Farmland placed in the nonmarital share was in danger of being deemed a future interest.[128] To complicate the problem, the IRS later ruled that if an estate representative had discretion in allocating estate assets between trusts or portions of trusts, and the beneficiaries of a trust or portion of a trust did not have a present interest, no assets subject to discretionary allocation by the estate representative would be eligible to meet the threshold requirements for special use valuation.[129]

A few months later, following a general public outcry against the IRS position, the IRS announced that discretionary payment of income or principal would not make land ineligible for special use valuation if all actual and potential beneficiaries were members of the decedent's family.[130] The Economic Recovery Tax Act of 1981 addressed the problem retroactive to January 1, 1977, by making interests in a discretionary trust present interests if all beneficiaries are qualified heirs.[131] In light of the 1981 legislation, it is important to (1) make all trusts discretionary trusts if there is any doubt about a qualified heir holding a present interest and (2) assure that all beneficiaries are members of the decedent's family.[132]

There are numerous situations in which beneficial interests in trusts may be future interests for reasons other than trustee discretion.[133] Transfers of property to a land trust have been held to create future interests when the transferors retained control over the land.[134] Similarly, transfers of nonincome producing real property to an irrevocable inter vivos trust are gifts of future interest when the trust authorizes the trustee to hold unproductive property and bars the trustee from selling the realty.[135] A trust for minors not meeting the requirements of section 2503(c) of the I.R.C.[136] would not meet the present interest test.

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128. Treas. Reg. § 20.2032A-8 (a) (2) (1980).

129. Ltr. Rul. 8244001, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5027 (1982); Ltr. Rul. 8114033, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5046 (1981).

130. News Release R-147, [1982] FED. EST. & GIFT TAX REP. (CCH) ¶ 12442, at 16, 108 (April 27, 1981).

131. Pub. L. No. 97-34, § 431 (j) (l) (amending I.R.C. § 2032A (g)). *See* Ltr. Rul. 8203011, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5038 (1982) (special use valuation available even though grandchildren who held the remainder interest did not have a present interest).

132. *See* Harl, *Special Use Valuation and Future Interests,* 5 J. AGRIC. TAX. & L. 271 (1983).

133. For an example of a discretionary trust creating future interests because of trustee discretion, see McManus v. Commissioner, 49 T.C.M. (P-H) ¶ 80296 (1980), *aff'd,* 1982-1 U.S. Tax. Cas. (CCH) ¶ 13456 (6th Cir. 1982).

134. *See* McClure v. United States, 608 F.2d 478 (Ct. Cl. 1979) (transfers deemed to be future interests to trust beneficiaries who received no present benefit).

135. *See* Maryland Nat'l Bank v. United States, 609 F.2d 1078, 1080-81 (4th Cir. 1979).

136. To meet the requirements of I.R.C. § 2503 (c), the trustee of a trust for minors must have the power to distribute the income and principal for the benefit of the minor. If the minor dies before reaching age 21, the trust income and principal must be payable to the estate of the minor or to

b. Non-Dividend Paying Corporations

A future interest problem may arise in instances in which a trust is not involved. For example, a transfer of a minority interest in corporate stock has been held to be a transfer of a future interest when the corporation had a history of no dividend declaration and the stock was subject to substantial restrictions on retransfer.[137] In these instances, the 1981 amendment on "discretionary trusts" is of no assistance. Farm and ranch corporations holding land that might otherwise be eligible for special use valuation, under these conditions, would be well advised to avoid creating a history of no dividend declaration.

c. Successive Interests

In recent years, concern has arisen over the creation of successive interests in farmland when all the interests are not held by members of the decedent's family.[138] If the decedent creates successive interests in real property, all the interests must vest in qualified heirs and all the interests must be specially valued if any part is valued under special use valuation.[139] Thus, leaving a remainder interest to a charitable organization precludes special use valuation for life interests left to eligible family members.[140] In the event a life estate is bequeathed to a qualified heir with a power to appoint the remainder interest to someone other than a qualified heir, special use valuation is not available.[141] The IRS has ruled, however, that if the qualified heir disclaims the power of appointment and the remainder interest vests in a qualified heir, the land is not ineligible for special use valuation.[142]

The more serious problem, from a drafting perspective, is whether a contingent devise to a charitable organization or non-family members would bar special use valuation when the probability of interests in land vesting outside the family is low.[143]

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whoever the minor may appoint under a general power of appointment. I.R.C. § 2503 (c) (West 1983).

137. *See* Berzon v. Commissioner, 534 F.2d 528 (2d Cir. 1976) (gifts to trust of stock deemed to be future interest because value of stock insusceptible to valuation).

138. *See* Harl, *Special Use Valuation and Future Interests*, 5 J. AGRIC. TAX. & L. 271, 274-75 (1983).

139. Treas. Reg. § 20.2032A-8 (a) (2) (1980). *See* Ltr. Rul. 8337015, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4379 (1983) (trustee discretion to distribute to non-family members bars special use valuation); Ltr. Rul. 8044018, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4851 (1980) (remainder interest to non-family members precludes special use valuation).

140. Rev. Rul. 220, 1981-2 C.B. 175.

141. Ltr. Rul. 8349008, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5781 (1983) (special power of appointment).

142. Rev. Rul. 140, 1982-2 C.B. 208 (special power of appointment).

143. *See* Treas. Reg. § 20.2032A-8 (a) (2) (1980) (special use value election precluded if property

In private letter rulings, the IRS has taken the position that if interests in the land could, even on a low-probability basis, pass to non-family members, special use valuation may not be elected.[144] For example, suppose *R*, by will, has left 640 acres of land in trust providing that income be paid to her husband for life and the remainder interest pass to her four children equally. In the event any child should die before the husband, the interest of that child is to pass to that child's issue. If there are no issue, the deceased child's portion is to pass to surviving children or issue of deceased children and if no issue of *R* survive, the property is to pass to *R*'s heirs as though *R* had died intestate under state law. Although the probabilities are high that all interests in the land will pass to members of *R*'s family, as defined for purposes of special use valuation,[145] there would be a low probability that all issue of *R* might predecease *R*'s spouse causing the property to pass to ineligible heirs. Such a possible outcome apparently would bar special use valuation of the land in *R*'s estate.[146]

Therefore, all interests in land to be specially valued, should vest in qualified heirs at the death of the property owner and any contingencies should be limited to passage of property interests within the group of qualified heirs. The instrument should provide explicitly that, in no event, are property interests to pass to non-qualified heirs. One possible solution is to vest all contingent interests in the last surviving member of the qualified heir group. Leaving contingencies in the passage of land can have catastrophic consequences in terms of special use valuation eligibility.

d. Entity Ownership of Land

Much of the literature on special use valuation and, to a substantial degree, the statute and accompanying committee reports, assume that land which is to be specially valued will be individually owned.[147] Section 2032A, however, clearly indicates

interest vests in family member subject to being divested in favor of non-family members). *See also* 4 N. HARL, *supra* note 3, § 43.03 [2] [d] [iii] [F].

144. Ltr. Rul. 8332012, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 3785 (1983) (special use valuation disallowed because of low probability that the property could pass to a non-qualified heir); Ltr. Rul. 8346006, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5456 (1983)(special use valuation disallowed because of possibility that the property could pass to a non-qualified heir); Ltr. Rul. 8349005, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5714 (1983). *But cf.* Ltr. Rul. 8321007, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 2355 (1983) (vested remainder subject to being divested did not preclude special use valuation).

145. See *supra* notes 46-49 and accompanying text for a definition of "member of family."

146. Ltr. Rul. 8346006, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5456 (1983); Ltr. Rul. 8349008, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5781 (1983).

147. *See* H. REP. NO. 94-1380, 94th Cong., 2d Sess., 21-28, *reprinted in* 1976 U.S. CODE CONG.

that entity-owned land should be eligible, but leaves the task of specifying eligibility requirements to the treasury regulations. The statute requires the decedent to have an "interest in a closely held business" within the meaning of that term for purposes of installment payment of federal estate tax.[148] For entity-owned land to be eligible for special use valuation, three basic tests must be met: The decedent must have an "interest in a closely held business," the "Tier I" test;[149] the decedent's interest in the closely held business must represent ownership of farm real and personal property equalling or exceeding fifty percent of the adjusted value of the decedent's gross estate, the "Tier II" test;[150] and twenty-five percent or more of the adjusted value of the decedent's gross estate must consist of the adjusted value of real property, the "Tier III" test.[151] In addition, other requirements must be met including the material participation test,[152] the qualified use test,[153] and the present interest test.[154]

i. Tier I test

To meet the Tier I test, the decedent must have an interest in a closely held business.[155] The decedent's interest in a partnership must comprise twenty percent or more of the total capital interest in the partnership or the partnership must have fifteen or fewer partners.[156] For corporation-owned land, the decedent's interest must comprise twenty percent or more of the value of the voting stock or the corporation must have fifteen or fewer shareholders.[157]

& AD. NEWS 3356, 3375-82. (Treasury Department would be directed to prescribe regulations for application of special use valuation to partnerships, corporations, and trusts).

148. I.R.C. § 2032A (g). The reference in § 2032A (g) to I.R.C. § 6166 (b) for a definition of an interest in a closely held business does not specifically encompass several ancillary provisions in I.R.C. § 6166 such as the aggregation rule for interests in two or more businesses, I.R.C. § 6166 (c); the elective attribution rule for partnership interests and non-readily tradable stock, I.R.C. § 6166 (b) (7); the automatic attribution rule for stock or partnership interests held by a husband and wife in co-ownership or as community property, I.R.C. § 6166 (b) (2) (B); and the rule on indirect ownership which considers property owned, directly or indirectly, by or for a corporation, partnership, estate or trust, to be owned proportionately by or for its shareholders, partners or beneficiaries, I.R.C. § 6166 (b) (2) (C). Therefore, these additional provisions would not seem to be applicable to entity ownership of land for purposes of special use valuation.

149. I.R.C. § 2032A (g). See *infra* notes 155-61 and accompanying text for a discussion of the Tier I test.

150. I.R.C. § 2032A (b) (1) (A). See *infra* notes 162-72 and accompanying text for a discussion of the Tier II test.

151. I.R.C. § 2032A (b) (1) (B). See *infra* notes 173-74 and accompanying text for a discussion of the Tier III test.

152. See *supra* notes 88-124 and accompanying text for a discussion of the material participation test.

153. See *supra* notes 71-87 and accompanying text for a discussion of the qualified use test.

154. See *supra* notes 125-46 and accompanying text for a discussion of the present interest test.

155. *See* I.R.C. §§ 2032A (g), 6166 (b) (1).

156. *Id.* § 6166 (b) (1) (B).

157. *Id.* § 6166 (b) (1) (C).

Neither corporate debt securities nor nonvoting stock is an interest in a closely held business for determining the percentage eligibility requirement.[158]

No statutory mention is made of comparable requirements for a trust. The Tier I test has been met for purposes of installment payment of federal estate tax even though the property was held in a revocable inter vivos trust at the time of death.[159] Therefore, it would seem that land held in trust should not be made ineligible for special use valuation if the requirements are otherwise met.

In general, a land owning entity must be engaged in a trade or business for the land to be eligible for special use valuation.[160] However, the IRS has ruled that the land may be eligible for special use valuation even though the land is held by an entity and leased under a passive rental arrangement provided that the land is leased to businesses owned by the decedent or members of the decedent's family.[161]

ii. Tier II test

As previously mentioned, the decedent's "interest in a closely held business" must represent ownership of farm real and personal property equalling or exceeding fifty percent of the adjusted value of the decedent's gross estate.[162] The statute does not specify how the "fifty percent test" is to be met for entity-owned land and the IRS has not yet issued regulations concerning this issue. The IRS has, however, adopted the "look through" approach, which disregards the entity and takes account of the farm real and personal property owned by the entity.[163] If the entity has a single class of ownership interest, application of the Tier II test is relatively straightforward. The entity-owned property is divided into property eligible for special use valuation and property not

158. *See Id.* § 6166 (b) (1) (C) (i). Section 6166 (b) (1) provides that stock in a corporation is an interest in a closely held business provided that "20 percent or more in value of the *voting* stock of such corporation is included in determining the gross estate of the decedent. . . ." *Id.* § 6166 (b) (1) (C) (i) (emphasis added). If the corporation has 15 or fewer shareholders, which is the case with most farm and ranch corporations, the Tier I test is satisfied notwithstanding the presence of preferred stock and debt securities. However, the presence of debt securities and preferred stock may have a substantial impact on whether the decedent's estate can meet the Tier II and Tier III tests. See *infra* notes 162-74 and accompanying text for a discussion of the Tier II and Tier III tests.

159. Ltr.Rul. 7747007, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 2246 (1977); Ltr. Rul. 8132027, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 6606 (1981).

160. *See* I.R.C. §§ 2032A (g), 6166 (b) (1).

161. *See* Ltr. Rul. 8206009, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5034 (1982).

162. I.R.C. § 2032A (b) (1) (A).

163. Ltr. Rul. 8108179, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5042 (1981) (corporate veil pierced to ascertain farm real and personal property owned by shareholder).

eligible for special use valuation and the decedent's percentage of ownership interest in the entity is applied to the eligible property. The following examples will help to illustrate this approach.

Example No. 1

> *S* died owning sixty percent of the common stock of a corporation owning $1,000,000 of farmland, $450,000 of farm machinery and livestock, $50,000 of cash needed in the business, and $500,000 of nonbusiness assets. For purposes of the Tier II test, *S*'s estate should be able to count $600,000 of farmland, $270,000 of farm machinery and livestock and $30,000 of business cash. These amounts should properly be added to eligible farm real and personal property owned directly by *S* to determine if the Tier II test has been met.

To date, no guidance exists on the amount of cash or cash-like items that may be counted as a business interest for purposes of the Tier II test. Apparently, the determination should be dependent upon the cash flow requirements of the farming operation involved, the amount of readily saleable grain and livestock in inventory,[164] and the time of the decedent's death relative to the normal pattern of income and expenditures for the year. In a similar setting, courts have sanctioned a highly quantified "operating cycle" formula in the determination of accumulations justified for purposes of the accumulated earnings tax.[165]

If the landowning entity has more than a single class of ownership interests, the task of determining whether the Tier II test is met becomes substantially more complex. Debt securities apparently would be treated as an investment asset and the value of the debt securities would, therefore, become a nonbusiness asset. Moreover, the underlying assets represented by the debt securities would probably not be eligible to be counted for purposes of the

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164. For purposes of installment payment of federal estate tax, grain in storage on the farm and at the local elevator has been held to be an interest in the business. Ltr. Rul. 8251015, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 6198 (1982) (the amount of cash considered to be working capital left to the District Director).

165. *See, e.g.*, W. G. Clark, Inc. v. United States, 1980-1 U.S. Tax Cas. (CCH) ¶ 9377 (E.D. N.C. 1980) (reasonable working capital reserve was 25% of "operational working capital needs" for farm supply and farm landowning corporation); Bardahl Mfg. Corp. v. Commissioner, 34 T.C.M. (P-H) ¶ 1123 (1965) (reasonable working capital reserve was 35% of expected annual operating costs for manufacturing corporation).

Tier II test. As indicated in Table 1,[166] the $100,000 of farmland, the $45,000 of machinery and livestock and the $5,000 of cash needed in the business would, by this analysis, be classified as nonbusiness, investment assets.

Because only assets in a "qualified use"[167] are eligible to be counted for purposes of the Tier II test, the question in determining the appropriate treatment for preferred stock and similar types of fixed principal equity interests would seem to be the extent the decedent or members of the decedent's family are "at risk" with respect to the land owning entity.

Example No. 2

> Assuming the basic facts in *Example No. 1,* assume further that the corporation has two classes of stock: $600,000 of common stock and $1,200,000 of preferred, in addition to $200,000 of outstanding debt securities. The preferred stock, therefore, would represent thirty percent of the corporate assets. Details of the ownership pattern are portrayed in Table 1.[168]

The issue is whether the assets represented by the preferred stock, $300,000 of farmland, $135,000 of machinery and livestock, and $15,000 of cash needed in the business, count for purposes of the Tier II test. If the common and preferred stock were not all owned by the decedent or members of the decedent's family, there would seem to be little doubt that the qualified use test would not be met for the assets represented by the preferred stock. If the decedent owned part of the outstanding common and preferred stock, and the decedent's family owned the rest, an argument could be made that the qualified use test would be met by "the decedent or a member of the decedent's family" for purposes of pre-death eligibility.[169] In that case, the ownership interest would encompass

166. Table 1
DETERMINATION OF CORPORATION OWNED LAND ELIGIBLE FOR USE VALUATION OF DEATH OF SHAREHOLDER

	Farmland	Machinery	Livestock	Cash Needed In Business	Non-Business Assets	Total Value
Common stock	600,000	120,000	150,000	30,000	300,000	1,200,000
Preferred stock	300,000	60,000	75,000	15,000	150,000	600,000
Debt securities	100,000	20,000	25,000	5,000	50,000	200,000
TOTAL	1,000,000	200,000	250,000	50,000	500,000	2,000,000

167. *See* I.R.C. § 2032A (b) (1983).
168. *See supra* note 166.
169. I.R.C. § 2032A (b) (2). *See* Treas. Reg. § 20.2032A-3 (b) (1) (1983).

the entire amount of risk from production and from price change. The two categories of risk would comprise the "at risk" feature.

In the event the amount of common stock in a corporation is small in relation to outstanding preferred stock, an argument can be made that holders of the preferred stock are "at risk." With a relatively small change in asset values, the equity represented by the common stock would be eliminated, which would essentially relegate the preferred stock to the "at risk" position normally associated with common stock.

The relationship of special use valuation to minority discount, nonmarketability, and other conventional adjustments to corporate stock valuation is not clear. Generally, the reduction of special use valuation from fair market value is not additive.[170] Rather, the appropriate approach would seem to be to utilize the lesser of the value of the stock under special use valuation and the value under conventional valuation with the various discounts taken into account.[171] Although the IRS has not ruled on the relationship between special use valuation and conventional discounts in stock valuation, it has taken the position that a minority discount was not allowable for valuation of a decedent's stock for purposes of the fifty percent test when the decedent owned less than fifty percent of the value of the stock and the decedent's interest combined with interests held by family members constituted a controlling interest.[172]

iii. Tier III test

To meet the Tier III test, the adjusted value of the decedent's real property must comprise at least twenty-five percent of the adjusted value of the decedent's gross estate.[173] For a single class of ownership interest, the decedent's percentage of ownership would clearly be applicable in determining the amount of entity-owned land eligible for special use valuation.

The more fundamental question is whether entity-owned land represented by fixed-principal equity securities is eligible for special use valuation. One approach to analyzing this issue would be to apply the "at risk" rules from the qualified use test. Under this approach, land represented by fixed principal equity securities would arguably be eligible. However, the basic justification for

170. *See* 8 N. HARL, *supra* note 3, § 58.02 [2] [c] [ii].
171. 8 N. HARL, *supra* note 3, § 58.02 [2] [c] [ii].
172. Ltr. Rul. 8302005, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 218 (1983).
173. I.R.C. § 2032A (b) (1) (B) (1983).

special use valuation was to provide federal estate tax relief because increases in land value had caused fair market values to exceed actual earning capacity based upon agricultural productivity.[174] With this in mind, it would seem improper for an estate to employ special use valuation to reduce further the value of a fixed or "frozen" preferred stock or limited partnership interest. Thus, it is doubtful that farmland represented by fixed principal ownership interests will be eligible for special use valuation.

II. POST-DEATH RECAPTURE

The principal focus of estate planners, commentators, probate practitioners, and farm families has been on meeting the pre-death eligibility requirements for special use valuation. After seven years of experience with special use valuation elections, the reality of recapture is causing a shift of focus to avoiding the traps that can lead to recapture.[175] Unfortunately, the law governing recapture is in a state of development with the guidance in some areas sketchy and incomplete.

A. EVENTS LIKELY TO CAUSE RECAPTURE

The apparent expectation of Congress was that land under special use valuation would continue to be used for farming purposes and retained by the family of the decedent during the recapture period after death. That rather simple expectation does not address, adequately, the plethora of fact situations that can arise during the period of recapture.

1. Transfer to Non-Family Members

Perhaps the event responsible for more instances of recapture than any other is the transfer of land subject to a special use valuation election to non-family members.[176] For purposes of this

174. *See* H. REP. No. 94-1380, 94th Cong., 2d Sess. 21-28, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3356, 3375-81. *See* JOINT COMM. ON INTERNAL REVENUE TAX'N AND THE CONG. RESEARCH SERV., SUMMARY OF STATEMENTS SUBMITTED TO THE FINANCE COMMITTEE ON TAX REVISION AND EXTENSION OF TAX REDUCTIONS 46-47 (1976) (summary of testimony on HR 1793 and S80).

175. For deaths before January 1, 1982, the recapture period is 15 years after death. *See* I.R.C. § 2032A (c) (West 1981), *amended by* The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421 (c), 95 Stat. 172, 307. For deaths after 1981, the recapture period is 10 years after death or 10 years after the commencement of use of the property in a "qualified use" during the two year grace period immediately after death. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421 (c), 95 Stat. 172, 307 (amending I.R.C. § 2032A (c)).

176. *See* I.R.C. § 2032A (c) (1) (A) (West 1983). A sale and leaseback within the recapture period constitutes a disposition. Ltr. Rul. 7934007, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 4357 (1979).

discussion, the term "member of family" is defined with respect to the *qualified heir,* not with respect to the decedent.[177]

For example, two brothers, *C* and *D,* farmed together for a number of years and each acquired a half section of land. *D* died and left his half section to his spouse, *E.* After *D*'s estate was settled, *E* decided to sell the land to *C.* Even though *C* was a member of her *husband's* family, *C* is not a member of *E*'s family. The federal estate tax benefits from special use valuation would be totally recaptured on a sale to *C.*[178] Ironically, as a member of *D*'s family, *C* could have purchased the land from *D*'s estate and the only adverse tax consequence would have been that *C* would take an income tax basis equal to special use valuation plus any gain recognized to the estate.[179] It is vitally important, therefore, to review plans for ultimate land ownership before transfer of the land from the decedent's estate.

Transfers of partial interests in special use value land can also lead to recapture.[180] Thus, disposition or severance of standing timber is a recapture event if the election has been made to treat the trees as part of the land.[181] Execution of an oil and gas lease is not a disposition when there is no interruption of the farming operation; but well-drilling activity, to the extent of interruption of the farming operation, is a disposition.[182] For land held in successive interests, recapture could occur on the transfer of some interests but not others. For example, *V* dies leaving 320 acres of farmland in trust with a life estate left to the surviving spouse, *W,* and the remainder interest held by *V*'s three children, *X, Y,* and *Z.* Five years after *V*'s death, the land is sold by the trust to *B, W*'s brother. *B* would be a member of *W*'s family as a qualified heir. However, *B* would not be a member of the family of *X, Y,* and *Z.* Presumably, recapture would occur regarding the transfer of the remainder interests but not regarding the transfer of the life interest.

Transfers of interests in entities owning land under a special use valuation election are subject to the same rules on transfer

177. See *supra* notes 46-49 and accompanying text for a discussion of the definition of "member of family."

178. *See* Ltr. Rul. 8133012, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5064 (1981) (sale of land by decedent's spouse to decedent's brothers was tranfer to non-family members).

179. See *supra* notes 58-62 and accompanying text for a discussion of qualified heirs' basis in property when purchased from the estate.

180. Recapture was especially treacherous on a transfer of partial interests when the IRS held the position that recapture was not proportionate in the event of a partial disposition. See *infra* notes 233-39 and accompanying text for a discussion of partial recapture of heir's interest.

181. *See* I.R.C. § 2032A (c) (2) (E). For a discussion of the election to treat trees as part of the land, see *supra* note 15 and accompanying text.

182. *See* Ltr. Rul. 8318070, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 2091 (1983).

concerning directly owned land.[183] Thus, although redemption of stock in a section 303 stock redemption[184] does not trigger recapture, reissue of the stock by the corporation to non-family members would be a recapture event.[185]

A partition of real property under a special use valuation election may constitute a disposition but no recapture tax is due if the transferee is a member of the transferor's family and agrees to be personally liable for any additional tax.[186] For all transfers of special use land to a family member, the new owner becomes liable for any recapture tax and the transferor is exonerated from liability.[187]

2. *Exchanges and Involuntary Conversions*

For exchanges occurring after 1981, recapture does not occur if qualified real property is exchanged in a tax-free exchange for "qualified exchange property."[188] If both qualified exchange property and other property are received in the exchange, the recapture tax is reduced by an amount bearing the same ratio to the recapture tax as the fair market value of the qualified exchange property bears to the fair market value of the property exchanged.[189] Qualified exchange property is real property used for the same qualified use as the property transferred.[190]

Recapture does not occur if qualified real property is involuntarily converted and "qualified replacement property" is acquired.[191] Qualified replacement property is real property used for the same qualified use as the property involuntarily converted.[192]

3. *Change of Use*

Changing the use of special use land from farming leads to

183. *See* Ltr. Rul. 8217017, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5050 (1982) (sale of stock by qualified heirs to corporation owned by remaining qualified heirs did not result in recapture).

184. *See* I.R.C. § 303. *See generally* 5 N. HARL, *supra* note 3, § 42.09.

185. Ltr. Rul. 8217075, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5029 (1982).

186. Ltr. Rul. 8120127, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5052 (1981). *See* Ltr. Rul. 8249014, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5037 (1982) (partition of qualifying property between qualified heirs does not trigger recapture); Ltr. Rul. 8213155, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5048 (1982) (partition of qualifying property between qualified heirs does not trigger recapture).

187. Ltr. Rul. 8115085, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5049 (1981).

188. I.R.C. § 2032A (i); Ltr. Rul. 8304106, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 445 (1983); Ltr. Rul. 8207050, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5047 (1982).

189. I.R.C. § 2032A (i) (1) (B).

190. *Id.* § 2032A (i) (3).

191. *Id.* § 2032A (h).

192. *Id.* § 2032A (h) (3).

recapture.[193] When tracts of land undergo development and transformation into a nonfarm use, this rule should not come as a great surprise. What constitutes a change of use, however, may be less obvious. If a farm residence is occupied by someone not involved in the farming operation,[194] or a new residence is constructed and occupied by one who is not working on the farm,[195] recapture would occur.

4. *Failure to Meet Qualified Use Test*

If a qualified heir fails to meet the qualified use test after the two year grace period[196] recapture occurs.[197] As previously noted,[198] the qualified use test requires that each qualified heir be "at risk" and have an equity interest in the farm operation.[199] The qualified use test in the post-death period, unlike the pre-death period, cannot be met by a member of a qualified heir's *family*. The test must be met *by each qualified heir*.

In general, a cash rent lease by the landowning qualified heir does not satisfy the necessary "at risk" feature.[200] A crop share lease,[201] livestock share lease, or even a nonmaterial participation crop share or livestock share lease should meet the qualified use

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193. *Id.* § 2032A (c) (1) (B).

194. Recapture does not occur if a specially valued residence is occupied by the owner, tenant, or employee of the owner or tenant for the purpose of operating or maintaining the real property. *See id.* § 2032A (c) (3).

195. *See* Ltr. Rul. 8306049, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 682 (1983) (disposition of five acre tract to one of the qualified heirs for construction of a residence to be occupied on a regular basis by the owner did not result in recapture when the purchasing qualified heir was involved in management of the farm).

196. *See* I.R.C. § 2032A (c) (7) (A). The two year grace period was added by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421 (k) (5) (A), 95 Stat. 172-14, retroactive to January 1, 1977.

197. I.R.C. § 2032A (c) (6) (A).

198. *See supra* notes 71-72 and accompanying text.

199. *See* S. REP. No. 97-144, 97th Cong., 1st Sess. 134, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 234. The Senate Report states:

> The bill does not change the present requirements that the qualified heir owning the real property after the decedent's death use it in the qualified use throughout the recapture period. . . . [T]he bill creates a special . . . grace period immediately following the date of the decedent's death during which failure by the qualified heir to commence use of the property in the qualified use will not result in imposition of an additional estate tax. The . . . recapture period is extended by a period equal to any part of the . . . grace period which expires before the qualified heir commences using the property in the qualified use. Failure by the heir to use the property in the qualified use after the . . . grace period would result in imposition of an additional estate tax.

Id.

200. *See* Ltr. Rul. 8307110, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 829 (1983) (children as qualified heirs not "at risk" with cash rent lease to sons of decedent's half-brother).

201. Ltr. Rul. 8217017, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5050 (1982) (crop share lease between corporation owning land and corporation as farm tenant 89% owned by family member met qualified use test).

test. In one letter ruling, a "bushel lease" met the test.[202] In that ruling, the landowner was to receive the first 40 bushels of corn or the first 13 bushels of soybeans; if actual production was less than those amounts, the landowner would receive the lesser figure.[203] The clause limiting the landowner's share to the amount of actual production apparently was crucial to the outcome of the ruling, which was in favor of the taxpayer.[204]

If successive interests in land are created under a special use valuation election, added care is needed in meeting the qualified use test.[205] In one letter ruling, the test was not met for the holder of a life estate when the land was cash rented to the life tenant's children as holders of the remainder interest.[206] Utilizing a crop share or livestock share lease, therefore, would seem prudent in all instances except when all holders of the various interests in the land are farm tenants. A crop share or livestock share lease should assure that the qualified use test is met even when a trustee has a discretionary right to distribute income.

The discretionary right to invade the principal for the holder of an interest who does not have an equity interest as a farm tenant poses special problems. If the principal is actually invaded, a question exists concerning whether recapture occurs. When a right to invade the principal is involved, the type of lease may not be determinative of whether or not the qualified use test is met. Until the question is resolved, avoiding the invasion of principal, whenever possible, would appear prudent.

Legislation enacted in 1983 provides that participation in the 1983 payment-in-kind program[207] by a qualified heir does not result in recapture of federal estate tax benefits because of failure to meet the qualified use test.[208] An IRS announcement broadened the rule to cover all government acreage diversion programs.[209]

5. *Failure to Meet Material Participation Test*

The absence of material participation for more than three years in any eight year period ending after death triggers recapture

202. Ltr. Rul. 8217193, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5051 (1982).
203. *Id.*
204. *Id.*
205. *See generally* Harl, *supra* note 87, at 274-75.
206. Ltr. Rul. 8240015, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5055 (1982) (surviving spouse who held life estate did not have equity interest in land rented to children under "net lease").
207. *See* 48 Fed. Reg. 1694 (1983).
208. Payment-in-Kind Tax Treatment Act of 1983, Pub. L. No. 98-4, § 3, 97 Stat. 7.
209. Announcement 83-34, 1983-10 I.R.B. 29.

of special use value benefits.[210] The material participation requirement must be satisfied by the qualified heir or any member of the *qualified heir's* family for the period during which the property is held by the qualified heir, and by the decedent or a member of the *decedent's* family during the time the property was held by the decedent.[211]

For example, *M* died with 160 acres of specially valued land passing to her four children by will. At *M*'s death, one son had predeceased *M*, leaving three grandchildren who shared their deceased parent's interest in the property. If the land is farmed by *D*, *M*'s oldest son, he would be an eligible material participator for the two living sisters but would *not* be an eligible material participator for the children of the predeceased son. *D* would not be a member of their family.[212]

For a qualified heir who is the surviving spouse of the decedent, a person who has not reached age twenty-one, a disabled individual, or a full-time student, the material participation test may be met by "active management" of the qualified heir.[213] The material participation test may be met by the active management of a fiduciary if the qualified heir is a person under age twenty-one or disabled.[214] Unlike the material participation test, the active management test *cannot* be met by a member of a qualified heir's *family*.[215]

The Payment-in-Kind Tax Treatment Act of 1983[216] provides that participation in the 1983 payment-in-kind program[217] does not trigger recapture of special use value benefits because of the absence of material participation in the diverted acres.[218] Prior to the enactment of the Act, it was believed that the recapture provision would apply when a taxpayer received agricultural commodities in exchange for idling land under the 1983 payment-

210. I.R.C. § 2032A (c) (6) (B) (West 1983).

211. *Id.* § 2032A (c) (6) (B) (i), (ii). *See* Ltr. Rul. 8217017, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5050 (1982) (material participation by family members for corporate owned land under crop share lease). *Cf.* Ltr. Rul. 8218008, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5052 (1982) (brother-in-law, as material participator, was not a member of qualified heir's family); Ltr. Rul. 8307110, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 829 (1983) (sons of decedent's half brother could not meet material participation requirement for decedent's children as qualified heirs).

212. See *supra* notes 46-49 and accompanying text for a discussion of the definition of "member of family."

213. I.R.C. § 2032A (c) (7) (B), (C). See *supra* notes 109-10 and accompanying text for a discussion of the meaning of "active management."

214. I.R.C. § 2032A (c) (7) (B), (C).

215. *Compare id.* § 2032A (c) (7) (B) (active management by qualified heir required) *with id.* § 2032A (c) (6) (B) (material participation by member of decedent's family meets qualified use test).

216. Pub. L. No. 98-4, 97 Stat. 7 (1983).

217. *See* 48 Fed. Reg. 1694 (1983).

218. *Id.*

in-kind program.[219] The IRS broadened the rule by announcing that participation in a government acreage diversion program would not lead to recapture of special use value benefits.[220]

6. *Change of Entity*

Apparently, Congress did not intend that recapture occur on a tax-free transfer of qualified real property to a partnership or corporation if certain conditions were met.[221] To avoid recapture, each qualified heir must retain the same equitable interest in the property as was held before the transfer, the partnership or corporation must be considered a closely-held business for purposes of installment payment of federal estate tax, and the partnership or corporation must consent to personal liability for recapture tax if the entity disposes of the real property or ceases to use the property for qualified purposes during the recaptue period.[222]

7. *Death of Qualified Heir*

Recapture of the federal estate tax benefits from special use valuation does not occur upon the death of a qualified heir.[223] In fact, the death of a qualified heir terminates the possibility of recapture of special use valuation benefits on the property involved.[224] For interests left to qualified heirs in successive interests, such as a life estate-remainder, recapture apparently does not cease before the end of the recapture period unless the holders of all the interests die.

8. *Mortgaging Special Use Land*

There is no authority on whether a mortgage or other credit obligation would constitute a disposition of an interest in the

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219. *Id.*

220. Announcement 83-43, 1983-10 I.R.B., 29.

221. H. REP. No. 94-1380, 94th Cong., 2d Sess. 25 n.3, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3356, 3379. *See generally*, 5 N. HARL, *supra* note 3, § 43.03[2][g][i][k].

222. *See* Ltr. Rul. 8217017, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5050 (1982) (transfer of interests in specially valued farmland in exchange for corporate stock not a disposition); Ltr. Rul. 8218073, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5053 (1982) (when corporation formed by qualified heirs, transfer of land under special use valuation to corporation did not cause recapture); Ltr. Rul. 8109073, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5043 (1981) (when qualified heir owned all stock after incorporation, no recapture resulted). *See also* Ltr. Rul. 8112022, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5045 (1980) (no recapture on passage of corporate stock by gift to qualified heirs when donees consented to personal liability for any recapture tax). In one letter ruling, a change of organizational form from a corporation, with common stock, preferred stock, and debentures, to a partnership did not cause recapture. Ltr. Rul. 8301045, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 91 (1983).

223. I.R.C. § 2032A (c) (1).

224. *Id.*

property for special use valuation purposes. If the funds obtained are used for nonfarm purposes, recapture seems more likely. However, if the funds generated remain invested in farm real or personal property, it would seem that there should be no recapture. Authority is lacking in this area.

B. RECAPTURE CALCULATIONS

When two or more qualified heirs are subject to the recapture of special use valuation benefits, the recapture calculations typically involve (1) a determination of the total potential liability for recaptured federal estate tax, (2) a determination of the portion of federal estate tax allocable to each qualified heir, and (3) a determination of the amount of each qualified heir's potential recapture liability that the particular recapture event triggers.[225] For situations with only one qualified heir, the recapture calculations are limited to the first and third determinations only.

1. *Potential Recapture Liability*

Upon the occurrence of any of the several events leading to recapture of special use valuation benefits, the first step is to calculate the potential for federal estate tax recapture. The potential for recapture is the "adjusted tax difference," which in most instances is the excess of the federal estate tax liability that would have been incurred had special use valuation not been utilized over the actual federal estate tax liability based on special use valuation.[226] The potential for federal estate tax recapture, however, may be less than the maximum amount calculated under the general rule. If disposition is by sale, the recapture amount is no greater than the gain on the sale — the selling price less special use value.[227] If disposition is other than by sale or exchange at arm's length, the recapture amount is no greater than the excess of fair market value of the property over the special use value.[228]

2. *Recapture Allocable to Each Heir*

When more than one qualified heir is subject to recapture, the

225. *See generally* Harl, *Events Causing Special Use Valuation Recapture — and How to Figure the Recapture Amount*, 5 J. AGRIC. TAX. & L. 157 (1983).
226. I.R.C. § 2032A (c) (2).
227. *Id.*
228. *Id.* § 2032A (c) (2) (A) (ii).

adjusted tax difference[229] is allocated among the qualified heirs in proportion to the respective reductions in value of their property interests from special use valuation.[230] The adjusted tax difference (ATD) for each heir is calculated as follows:

$$ATD = \frac{\text{FMV of heir's interest less its special use value}}{\text{FMV of all qualified property less its special use value}} \times \text{Estate tax calculated with fair market values les allowable credits minus the estate tax calculated using special use value less allowable credits}$$

Thus, the maximum recapture tax imposed with respect to any heir's interest is the portion of the total potential tax on all specially valued property that the fair market value of the heir's property interest bears to the total fair market value of all specially valued property.[231] If each of three qualified heirs inherits an undivided one-third interest in each parcel of real property, for example, the maximum recapture liability for each qualified heir is one-third of the total.[232]

3. *Recapture Liability for Part of Heir's Interest*

The third step in calculating the recapture amount is determining the amount of each qualified heir's potential recapture liability that is triggered by a particular recapture event. If all of a qualified heir's property interest is transferred or otherwise ceases to meet the post-death conditions necessary to avoid recapture, the amount recaptured is all of the federal estate tax allocated to that heir.[233] For partial dispositions of a qualified heir's interest, the position of the IRS, until late 1983, was that the recapture amount was disproportionately large.[234] The IRS view was that the recapture amount was the lesser of the federal estate tax saved by the decedent's estate with respect to the heir's interest or the excess of the amount realized on the disposition over the pro rata portion of the special use value of the heir's interest.[235] Thus, from 1980

229. See *supra* notes 226-28 and accompanying text for a definition of adjusted tax difference.

230. I.R.C. § 2032A (c) (2) (B). *See* Ltr. Rul. 8218008, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5052 (1982) (amount of additional tax is the amount of tax savings attributable to special use valuation of heir's interest).

231. I.R.C. § 2032A (c) (2). *See* Ltr. Rul 8249014, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5037 (1982) (upon partition of specially valued property held by three qualified heirs as tenants in common, each heir is potentially liable for one-third of estate tax saved by special use valuation).

232. Ltr. Rul. 8249014, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5037 (1982).

233. *See* I.R.C. § 2032A (c) (2).

234. *See generally* 5 N. HARL, *supra* note 3, § 43.03 [2] [g] [ii].

235. *See* Ltr. Rul. 8215036, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5049 (1982).

through late 1983, recapture computations were based upon the federal estate tax saved with respect to all of the specially valued real property received by the qualified heir.[236] The IRS explained its position in an early 1982 letter ruling as follows:

> If the qualified heir received 100 acres with a special use value of $5,000 per acre and the estate tax savings as a result of the 2032A election in the decedent's estate with respect to that interest was $50,000, the recapture tax imposed on the sale of 1 acre of specially valued property would be the lesser of (1) $50,000 (the adjusted tax difference attributable to the heir's interest) or (2) the amount realized on the sale in excess of $5,000.[237]

The IRS interpretation was not the only way to view the statute. The statute was readily interpreted as calling for proportionate recapture; with the amount recaptured proportionate to the portion of the heir's interest failing to meet the requirements to avoid recapture.[238] The difference in interpretations hinges on the meaning of "interest" in the statute.[239]

In a letter ruling published in late 1983,[240] the IRS changed its position. Under the revised interpretation, the amount of federal estate tax recaptured is proportionate to the amount of property transferred outside the family or otherwise ceasing to meet the post-death requirements to avoid recapture.[241] In the ruling, a personal residence was built in 1978 on a two acre tract of land under a special use value election. The land involved was owned by two qualified heirs, each of whom had an undivided one-half interest in the land. Each undivided one-half interest had a date of death fair market value of $2250 and a special use value of $584. All the land under special use valuation had a fair market value at death of $704,000 and a special use value of $211,400. The total amount of federal estate tax saved was $127,000. The formula used by the IRS for calculating the recapture amount was:

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236. Ltr. Rul. 8308004, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 895 (1983).
237. *Id.*
238. *See* 5 N. HARL, *supra* note 3, § 43.03 [2] [g] [ii].
239. *See* I.R.C. § 2032A (c) (2).
240. Ltr. Rul. 8350035, [Priv. Ltr. Rul.] FED. TAXES (P-H) ¶ 5910 (1983).
241. *Id.*

$$\text{Amount recaptured} = \frac{\$2250 - \$584}{\$704{,}000 - \$211{,}400} \times \$127{,}000$$

$$= \frac{\$1666}{\$492{,}600} \times \$127{,}000$$

$$= \$429.52$$

Regulations are expected to be issued reflecting the new IRS interpretation.

The former IRS interpretation posed a major trap for the unwary who unknowingly assumed that recapture was proportionate to the property disposed of or otherwise ceasing to meet the post-death conditions necessary to avoid recapture. That problem has now been eliminated.

C. INCOME TAX BASIS CONSIDERATIONS FROM RECAPTURE

For the first five years of its existence, special use valuation provided no adjustment in income tax basis in the event of recapture.[242] The income tax basis from special use valuation remained after recapture. This rule continues to be the rule for deaths before 1981.

For deaths after 1981, however, upon recapture a qualified heir may elect to increase the income tax basis of the property by the amount that the date of death fair market value or the fair market value on the alternate valuation date exceeds special use value.[243] If the qualified heir elects to increase the income tax basis, the qualified heir must pay interest on the tax recaptured[244] from nine months after death.[245] The increase in basis is deemed to have occurred immediately before the recapture event.[246] If the qualified heir does not make the election and pays the interest, no adjustment is made to the basis of the property. The election to increase the income tax basis is irrevocable and is made by filing a statement with Form 706-A.[247]

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242. The additional federal estate tax on recapture is imposed under I.R.C. § 2032A rather than I.R.C. § 2001.

243. I.R.C. § 1016(c).

244. *See id.* § 6621.

245. *Id.* § 1016(c)(5)(B).

246. *Id.* § 1016(c)(3).

247. *See* Temp. Treas. Reg. § 5c.0, T.D. 7793, 1981-2 C.B. 62. The statement on which the election to increase the basis of recapture property is made is to (1) contain the name, address, and

III. OTHER CONSIDERATIONS

Two other topics in the area of special use valuation of vital importance to practitioners are the special lien on all qualified farm or closely held business real property for which a special use valuation election has been made[248] and the special use value election itself.[249] These topics are discussed in detail elsewhere and are not covered in this Article.[250]

IV. CONCLUSION

For a tax provision less than eight years old, special use valuation has commanded an unusually large amount of attention on the part of estate planners, probate practitioners, and farm families. Whether special use valuation will merit continuing attention depends upon the future course of land values and cash rents and whether the unified credit[251] continues to phase-in to a level of $192,800 (equivalent to a deduction of $600,000) in 1987. Conceivably, with a plateauing or even further declines in land values and with a phase-in of the unified credit as scheduled, special use valuation may be receiving less attention in 1987 and beyond than in 1984. On the other hand, further increases in land values and a freeze in the level of the unified credit, at 1984 or 1985 levels, would assure a more significant role for special use valuation.

One point appears certain: so long as special use valuation offers significant property valuation advantages, the concept will likely continue to become increasingly complex. As noted in the introductory paragraphs of this Article, special use valuation is well on its way to becoming the most complex section in the entire Internal Revenue Code.

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taxpayer identification number of the qualified heir and of the estate; (2) identify the election as under I.R.C. § 1016 (c); (3) specify the property with respect to which the election is made; and (4) provide any additional information required by the Form 706-A instructions. *Id.* at 65.

248. I.R.C. § 6324B. *See generally* 5 N. HARL, *supra* note 3, § 43.03 [2] [i].

249. I.R.C. § 2032A (d) (1); Treas. Reg. § 20.2032A-8 (a) (3) (1980). *See* 5 N. HARL, *supra* note 3, § 43.03 [2] [h].

250. *See* 5 N. HARL, *supra* note 3, §§ 43.03 [2] [i] (special lien); 43.03 [2] [h] (election).

251. *See* I.R.C. § 2010.